HOW-INT (1)

MAR 29 1944
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

No. 824

KATIE M. HOWELL, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 825

ESTATE OF J. H. HOWELL, DECEASED, *Petitioner*.

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

ROBERT ASH,
Munsey Building,
Washington, D. C.,
Attorney for Petitioner.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX

Page

PETITION 1

Jurisdiction 2

Question Presented 2

Summary Statement of Matter Involved 3

Reasons Relied on for the Allowance of the Writs.. 5

BRIEF IN SUPPORT OF PETITIONS FOR WRITS OF CERTIORARI 13

Opinions Below 13

Jurisdiction 13

Statute Involved 13

Specification of Errors 14

Statement of the Case 14

Argument 18

Conclusion 18

TABLE OF CASES

Alworth-Stephens Co., Lynch v., 267 U. S. 364..... 7

Anderson v. Helvering, 310 U. S. 404 .....6, 7, 9

Biwabik Mining Co., United States v., 247 U. S. 116.. 7

Hammel, Helvering v., 311 U. S. 504 12

Harmel, Burnet v., 287 U. S. 103.....4, 5, 9, 17

Hodges, Hugh, Drilling Co., 43 B. T. A. 1045..... 10

McFeely v. Commissioner, 296 U. S. 102..... 12

Palmer v. Bender, 287 U. S. 551..... 6

Sargent Land Co., Van Baumbach v., 242 U. S. 503... 7

Shaffer, John C., 28 B. T. A. 1294 10

OTHER AUTHORITY CITED.

General Counsel's Memorandum 2270, C. B. Dec. 1927, p. 216 .....8, 10

143955

IN THE

Supreme Court of the United States

No. .....

KATIE M. HOWELL, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. .....

ESTATE OF J. H. HOWELL, DECEASED, *Petitioner*.

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable, The Chief Justice and The Associate Justices of the Supreme Court of the United States:

PETITION.

Katie M. Howell, individually, and as Executrix of the Estate of J. H. Howell, deceased, by her counsel, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Fifth Cir-

cuit entered in the above-entitled cases February 8, 1944 (R. 69-75)[1], affirming a decision of The Tax Court of the United States (R. 15-23) sustaining deficiencies in income tax for the calendar year 1939 in the amount of $9,710.18 against Katie M. Howell individually, and in the amount of $9,710.19 against Katie M. Howell, Executrix.

JURISDICTION.

The judgments of the Circuit Court of Appeals sought to be reviewed were entered February 8, 1944. Jurisdiction to issue the writs requested is found in Section 240 of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

1. In dealing with oil and gas properties for Federal tax purposes, should the ownership of the "economic interest" in the petroleum be considered, or should only legal titles be recognized?

2. The decision of the foregoing question will dispose of the ultimate question, which is the length of time Howell owned the interest which was sold to the Buffalo Oil Company.

If Howell owned an "economic interest," as petitioner contends, he owned it for more than eighteen months and the gain on its sale should be taxed as long-term capital gain. If Howell owned nothing when he acquired the right to enter upon and exploit the land, and the thing of value involved is the "lease," rather than the "economic interest," as held by the Court below, the gain is taxable as short-term capital gain.

---

[1] References are to the printed record in No. ...., *Katie M. Howell* v. *Commissioner of Internal Revenue*. By stipulation between the parties, only one record has been printed, as the cases are identical and were disposed of on one record and by one opinion by The Tax Court and the Circuit Court of Appeals. In the Circuit Court of Appeals only one record was printed. Two appeals were filed because the income involved was reported on the community property basis by Howell and his wife in separate returns.

Petitioner contends that the only thing of value involved was the "economic interest," or the right to enter upon the land and exploit it for petroleum. The Court below held that the "lease," and not the right to enter upon and exploit the land, is the thing of value involved.

SUMMARY STATEMENT OF MATTER INVOLVED.

Petitioner's husband, J. H. Howell, on October 6, 1937, entered into a "contract" with W. P. Ferguson, under which he was given the right to enter upon certain of Ferguson's land and explore for petroleum. If a well were started by Howell on or before November 21, 1937, a "lease," also executed October 6, 1937, and which was to be placed in escrow, was to be delivered to Howell. Actually, the "lease" was delivered to one of Howell's coowners on October 6, 1937. The "contract" gave Howell all of the rights customarily given by an oil and gas "lease," except the right to defer the drilling of a well by the making of rental payments. (R. 16-17, 39-46.)

On October 26, 1937, Howell entered into an agreement with Consolidated Oil Company whereby he agreed to convey to the company a three-fourths interest in the acreage covered by his "contract" with Ferguson, in consideration of $5,000 in cash and the assumption by Consolidated of all of Howell's obligations under the "contract" with Ferguson, including the obligation to start the well on or before November 21, 1937. (R. 18, 47-48.)

The well was started by Consolidated November 16 or 17, 1937, and the "lease" delivered to petitioner's husband that day. (R. 18, 37.) November 19, 1937, petitioner's husband, J. H. Howell, assigned a three-fourths interest in the "lease" of October 6, 1937, to Consolidated. On the same day, Howell and Consolidated assigned to H. S. Gray all of their interest in the lease insofar as it covered a described tract of land containing twenty acres, more or less. (R. 18, 37, 38.)

On April 10, 1939, petitioner's husband, J. H. Howell, and Consolidated assigned their entire seven-eighths working interest in about half of the land covered by the "lease" to Buffalo Oil Company for $700,000 cash, of which petitioner's husband, J. H. Howell, received $175,000. (R. 18, 38.)

The question for decision is the period of time Howell held the rights which he sold April 10, 1939.

The Tax Court disposed of the case on the theory that the piece of paper called a "lease" was the property sold, rather than the "economic interest" in the petroleum represented by the right to enter upon, explore for and extract the mineral conveyed by the "contract" and the "lease." In other words, it held that ownership of the rights sold dated from the time the formal piece of paper called a "lease" was delivered to Howell, and not from the time Howell actually acquired the "economic interest" in the petroleum. The taxpayer takes the position that the thing sold was an "economic interest" in the petroleum. That "economic interest" was held from October 6, 1937, when Howell acquired the right to enter upon the land and explore for and extract the minerals, which was more than eighteen months prior to the sale. (R. 20-23.)

The Circuit Court of Appeals, without citing a single oil and gas decision, disposed of the case on the ground that the transaction was a sale of oil and gas in place, stating (R. 73):

> "Under the law of Texas, an oil lease is a present sale of oil and gas in place. That is the substance of what taxpayer acquired when the lease in question was delivered. * * * The purchasers did not pay $700,000.00 for an 'economic interest.' They paid $700,000.00 for oil and gas in place, plus the right to take it, as evidenced and made secure to them by the execution of a valid and legal document, to-wit, a lease."

The Circuit Court opinion does not mention *Burnet* v. *Harmel,* 287 U. S. 103, where the taxpayer, in a capital

gain case, made the identical contention as that stated by the Circuit Court. This Court denied the taxpayer's contention and reversed the Fifth Circuit in the *Harmel* case.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRITS.

I.

The decision below is in conflict with Burnet v. Harmel, 287 U. S. 103.

In the *Harmel* case, the taxpayer contended that a bonus received for executing an oil and gas lease on Texas land should be taxed as capital gain because, under Texas law, such a lease was a present sale of oil and gas in place. This Court specifically denied the taxpayer's contention and reversed the Fifth Circuit (56 F. (2d) 153). In discussing leases in states where title to the oil passes only on severance by the lessee, as compared with Texas leases, this Court states (p. 111):

> "The economic consequences to the lessor of the two types of leases are the same. Under both, the payments made by the lessee are consideration *for the right which he acquires to enter upon and use the land for the purpose of exploiting it*, as well as for the ownership of the oil and gas * * *." (Italics supplied.)

In the case at bar, the Circuit Court opinion does not refer to the *Harmel* case and specifically holds (R. 73):

> "Under the law of Texas an oil lease is a present sale of oil and gas in place. That is the substance of what taxpayer acquired when the lease in question was delivered. That is what the taxpayer sold to Buffalo Oil Company. The purchasers did not pay $700,000.00 for an 'economic interest.' They paid $700,000.00 for oil and gas in place, plus the right to take it, as evidenced and made secure to them by the execution and delivery to them of a valid and legal document, to-wit, a lease."

Both the *Harmel* case and the case at bar are capital gains cases. The *Harmel* case held it was immaterial if, as a matter of state law, an oil and gas lease was a present sale of the oil in place. The case at bar turns on the holding that, under Texas law, such a lease is a present sale of oil and gas in place.

It is true that the *Harmel* case did not involve a determination of the length of time the asset was held. However, that case did squarely hold that, for Federal tax purposes, the right involved is the right to enter upon and exploit the land. Howell clearly owned that right for more than eighteen months.

When Consolidated paid Howell $5,000 in cash and assumed the responsibility of drilling the obligation well, it believed Howell owned something. The Court below apparently thinks otherwise.

II.

The decision below is in conflict with numerous decisions of this Court which hold that the burdens and benefits of the taxing statute apply to the person owning the "economic interest," rather than to the person holding legal title to oil and gas property.

Typical of the cases are:

Palmer v. *Bender,* 287 U. S. 551, which holds that the depletion deduction is allowable to the person who has the right to share in the oil produced; that is, by the owner of the "economic interest." In the case at bar, Howell owned the right to share in the oil produced for more than eighteen months.

Anderson v. *Helvering,* 310 U. S. 404, holds that ownership of an "economic interest" is not dependent (p. 411) "upon the particular instrument involved, or upon the formalities of the conveyancer's art."

The case at bar certainly went off on "formalities of the conveyancer's art," and not upon the interests involved.

The *Anderson* case also holds (p. 407):

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."

Stated another way, the ownership of the "economic interest" is the governing factor.

United States v. *Biwabik Mining Co.*, 247 U. S. 116, and *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, both hold that mineral leases are not conveyances of the mineral in place, but are "grants of the privilege of entering upon, discovering, and developing and removing the minerals from the land" (Biwabik, p. 123).

In the case at bar, the petitioner owned the rights mentioned more than eighteen months.

Lynch v. *Alworth-Stephens Co.*, 267 U. S. 364, holds that the right to reduce the mineral to possession is an interest in property.

From the very inception of the income tax, this Court has uniformly held that ownership of the right to share in the mineral produced (which this Court describes as an "economic interest") is the determinative fact with respect to income and to deductions. This is true because the only thing of value is the right to extract the mineral. Legal title without the "economic interest" is valueless.

In the case at bar, the Court below ignores established law and reality and disposes of the case entirely on the length of time legal title was held; this despite the fact that at all times the parties were concerned only with the right to explore for and extract the mineral.

Nothing but confusion will result if, at this late date, cases involving the taxation of oil and gas properties turn on legal title, rather than on "economic interest."

III.

The decision below is in conflict with long-established practice of the Bureau of Internal Revenue.

This is illustrated by General Counsel's Memorandum 2270, Cumulative Bulletin, December, 1927, page 216, which involved an oil lease which was placed in escrow until payment was made by the vendees starting wells at designated places, by development by the vendees, by the maintenance of the properties unencumbered by liens, and by certain payments out of oil . In the event any of the conditions were not fulfilled, title was to revert to the vendors. The General Counsel of the Bureau states:

> "But the contract also clearly contemplates that from the date of delivery in escrow of the executed assignment the vendees are entitled to possession under the lease. The contract is unmistakably clear that the possession to which the vendees are thus entitled upon the delivery in escrow is possession as lessees, and that the vendees have the right to use the properties as their own to the same extent as is customary with a mortgagor. From that time the vendees are entitled to the profits of the lease. (*Tucker* v. *McLaughlin-Farrar Co.*, 36 Okla., 321, 129 Pac., 5.) From that time the vendees have every right of ownership not inconsistent with the security of the vendors, including the risk of loss and the opportunity for profit. (*Miller* v. *Waddingham*, 91 Cal., 377, 27 Pac., 750, 13 L. R. A. 680; *Baker* v. *Bishop Hill Colony*, 48 Ill., 264; *Baldwin* v. *Pool*, 74 Ill., 97.) It is, therefore, evident that under the contract as of the time of delivery in escrow by the vendors of the executed assignment all the beneficial incidents of ownership in the lease passed to the vendees and as of that time the vendees became possessed of such a property in the oil and gas lease as to entitle them to an allowance of a deduction for depletion under section 214(a) 10 or section 234(a)9, Revenue Act of 1921, and the regulations prescribed thereunder. I. T. 2275 (C. B. V-1, 62) and ruling therein cited.

"The delivery in escrow of the assignment of the lease deliverable from escrow to the vendees only upon the happening of the condition stipulated in the escrow agreement results in the retention of the title to the lease by the vendors, but this retention of title is merely as security for payment of the purchase price. The escrow was but a short way of accomplishing the same thing as would be achieved by assigning to the purchaser and taking a mortgage back. After the time when the assignment is delivered in escrow the vendors' rights are merely for the purpose of security and all the beneficial incidents of ownership are in the vendees. Such rights of ownership as the vendors possess are rights of security subordinate and incident to the debt or obligation of the vendees for the purchase price. One possessing only a security or a mortgage interest in oil and gas property can derive no income from the property as such; * * *."

The General Counsel's Memorandum emphasizes and turns on the fact of possession. This is consistent with the holding in *Burnet* v. *Harmel*, 287 U. S. 103, that an oil and gas lease is merely a right to enter upon land and exploit it. Under *Anderson* v. *Helvering*, 310 U. S. 404, that right is not dependent "upon the particular instrument involved."

To say that the rights described in G. C. M. 2270 as above quoted, and as exist in the case at bar, are not the real rights involved in the case is to completely ignore reality.

In connection with the foregoing, it should be remembered that *Anderson* v. *Helvering*, 310 U. S. 404, 407, holds "that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."

It is axiomatic that a deduction for depletion belongs to the person owning the mineral which is depleted by production. The Treasury Regulations (Reg. 103, Sec. 19-23(m)-1) provide that " the owner of an economic interest * * * is allowed annual depletion deductions."

IV.

The action of the Circuit Court of Appeals in resting its opinion on the ground that a well had to be drilled as a condition precedent to the vesting of Howell's interest is in conflict with the established law and practice of the oil industry.

The requirement that a well be commenced before November 21, 1937, was in the nature of consideration given in exchange for the right to extract the mineral. The drilling of such "obligation" wells is a common method of paying for interests in oil-producing property. *Hugh Hodges Drilling Co.*, 43 B. T. A. 1045.

In G. C. M. 2270, wells had to be started at specific times and places, development had to be done, the property had to be maintained unencumbered, and payments had to be made out of oil. However, those conditions, as in the case at bar, were merely payments.

There is no requirement in the statute that a capital asset must be fully paid for before the holding period starts to run. The time begins when the property or right is acquired, not when it is paid for.

> "In other words, the two-year period mentioned in section 208(a)(8) begins to run from the date of petitioner's acquisition of the property, and not from the date of payment therefor or the date when additional costs is respect thereof were incurred." *John C. Shaffer*, 28 B. T. A. 1294, 1309.

There is nothing unusual in the Howell transaction because Howell was required to take additional action after acquiring his right to enter and explore in order to retain that right. The same condition exists in connection with practically all commercial oil and gas leases, which ordinarily provide:

(a) The original consideration pays for the rights for a designated period of time, usually a year.

(b) A well must be drilled, or a rental paid, if the rights are to be extended beyond the original period.

(c) A rental must be paid for each year or other period in the absence of a well.

(d) If oil is discovered, continuous and orderly development of the lease must be conducted.

(e) Boundary wells on adjoining property must be immediately offset.

(f) The lessee must not cease to produce oil from the lease after the term of the lease, but must continue to produce as long as oil can be produced in commercial quantities.

In other words, persons owning "economic interests" in oil leases must continue to perform under those leases or their rights lapse. That is exactly the situation in the case at bar.

V.

The decision of the Circuit Court of Appeals will cause confusion and uncertainty regarding the taxability of oil transactions which will restrict such transactions and detrimentally affect the public revenue.

In this case, Howell fully understood that the taxation of oil and gas transactions depended upon ownership and transfer of the "economic interest." He and all others in the oil industry have every reason to so understand because of the repeated decisions of this Court. It will be a cruel thing, because Howell had faith in the decisions of this Court, if such decisions are disregarded and his widow is compelled to pay an additional tax of nearly $20,000, plus interest.

The greatest public criticism of income taxation is its complexity and uncertainty. Such complexity and uncertainty as reflected by the statute should not be increased by a complete disregard of this Court's decisions on the thoroughly settled question of "economic interests" in

mining properties. If such a condition is permitted, taxpayers will be discouraged from engaging in taxable transactions. The purpose of the capital gains section will thus be defeated[1] and the public revenue adversely affected.

VI.

The decision of the Circuit Court of Appeals is in conflict with McFeely v. Commissioner, 296 U. S. 102.

In the *McFeely* case, the Commissioner contended that, for capital gains purposes, ownership of property acquired from a decedent through intestacy dates from the time of distribution, and not from the time of the decedent's death. This Court rejected the contention, stating the result "would be to penalize the taxpayer by lengthening the period during which the capital asset must be held in what is really a single ownership to obtain the advantage of the reduced tax" (p. 111).

Stated another way, in the *McFeely* case the Commissioner insisted, as he insists here, that legal title governs. This Court held that the date of decedent's death governs, irrespective of local law regarding the passing of title to legatees or next of kin.

In the case at bar, the action of the Circuit Court of Appeals, in basing its decision on acquisition of formal legal title, is in conflict with the principle of the *McFeely* case.

---

[1] The purpose of the capital gains section is for "encouraging profit-taking sales of capital investments." *Helvering* v. *Hammel*, 311 U. S. 504, 509.